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THE TAXATION OF CORPORATIONS

With the single exception of our municipal government, we have failed most completely with the subject of taxation. Our problems of taxation are becoming more complex with the constant change and development of our social, economic, and industrial conditions, and we must more promptly and completely adjust our fiscal methods to our more highly developed civilization.

The general property tax is not adequate nor suitable for the industrial and economic development of to-day and as actually administered is uniformly unsuccessful. It sins against both cardinal principles of universality and uniformity in taxation. Every time one makes out his tax list as required by law he necessarily perjures or robs himself, and even then this system fails to secure anything approaching uniformity in practice. It is responsible for the all too prevalent feeling that it is just as legitimate to dodge taxes as death.

Officials of taxation everywhere declare that instead of actually taxing personal property the general property tax becomes a tax upon ignorance and honesty, for, in practice, it is generally imposed upon those who do not know how to evade the tax or are restrained by a nice sense of honor from doing so. It thus penalizes integrity and puts a premium on perjury. Even the scrupulously honest tax payer cannot concede that he is under obligation to pay other men's taxes, although under a fair system of taxation where all contribute according to their ability, practically everyone would willingly assume his fair share of the burden, because each would know that all others were paying their share.

We all agree with our state boards of tax commissioners in the statement so often repeated that there is a shocking lack of uniformity in the assessments of various items of personal property, and that many state boards have no adequate way of correcting such inequalities. Bank stock is assessed at 60 per cent. of its market value in one county and at 85 per cent. in an adjoining county, while money and credits are assessed at 100 per cent. or more commonly not at all. While personalty, especially in industrial centers, constitutes the greater part of all property it only pays a nominal part of the taxes and even

a relatively decreasing portion, although this form of property is increasing out of all proportion to other property.

If we would have personal property, and especially intangible personalty, pay its fair share of taxes, property must be classified for the purposes of assessment. It is not possible nor even reasonable to suppose that in our present advanced civilization all property, with its varied forms and complex relations, can be reached for purposes of assessment in the same way or taxed by the same method.

At all times and in all countries it has been found almost impossible to list intangible personal property for the purpose of taxation. The difficulties in obtaining a fair share of taxes from this source have been greatly extended and multiplied by the complexities attending the growth and development of the modern business corporation, for in our industrial centers by far the greater portion of all property is in the form of such intangible personalty as corporate securities. And while as a matter of fact real estate and indeed most all tangible property having a fixed situs may be fairly well assessed locally and in the same general way, the vast and rapidly increasing portion of our wealth is in the form of intangible property which is not and can never be reached for taxation under our present system. This property must be assessed according to its form and at the place of its investment, and the tax collected at the source.

In separating the sources of state and local revenue, let the localities impose a tax sufficient to provide their necessary local revenue on the real property and on the tangible personal property belonging to individuals, firms, and the local mercantile, manufacturing and miscellaneous corporations, leaving the financial and insurance companies and public service corporations, which frequently operate beyond the local taxing jurisdiction and are under the direct control of the State, to be assessed and taxed directly by the State itself for the purpose of providing the state revenue.

The inherent difficulty of making a fair valuation of the property, and especially the large portion of intangible property belonging to public utilities as going concerns with the ability to earn, and actually earning, a definite income therefrom, makes it impossible to secure a fair and uniform assessment of such corporations by local taxing officials. This is because their jurisdiction is frequently more limited than the operation of the public utility assessed, and for the further reason that such local

officials have not the expert assistance nor the funds at their disposal necessary to make a correct valuation of the business as a single operating entity. Each local taxing jurisdiction naturally assesses in its own way and at its own valuation a segregated portion of a general system or one of many similar concerns, independently of the remaining portion or of other like utilities, with glaring inequalities resulting inevitably.

The advantages of separating the sources of state and local revenue would consist not only in furnishing a practical basis of classifying property for the purpose of its assessment but in obviating the necessity for boards of equalization which are now required to limit and, as far as may be possible, to overcome the natural tendency of each locality to assess its property at the minimum in order to escape as much state tax as possible, the state tax being now apportioned according to local assessment rather than local expenditure. With the sources of revenue completely separated each locality would be free to assess at its own valuation, for the rate would vary accordingly and this would be entirely independent of the State, which would levy upon other property, not taxed by the localities, to secure the necessary state revenue. This system would secure greater freedom in fiscal matters to the localities or more complete home rule on questions pertaining exclusively to the revenue and expenditure of local government, and also a more highly centralized system of taxation for the State in raising its revenue direct.

Still more important, however, such a separation of state and local revenue would permit of the classification of property according to its form and furnish practically a complete assessment. The bulk of intangible property being corporate in form would be assessed by the State which, having the means for the supervision or for the valuation of these corporations already available, could much more fairly and conveniently assess such concerns as single entities or operating systems. The public service commission has the verified reports from which, with information of its own, it is now required to make valuations of our public utilities. From such data, indicating the extent of their investment, income or earning capacity, the state board of tax commissioners could easily and at slight expense make fair, uniform and adequate assessments of such corporations just as they can of financial institutions, insurance companies, and certain other corporations from the verified reports they make to the State.

Vermont offers a striking example of the practical advantages to be derived from a separation of the sources of state and local revenue, which according to the commissioner of taxes has proven entirely satisfactory. The aggregate amount of taxes collected from corporations has been constantly increasing and has proven altogether adequate for the increasing state expenditures. This plan was authorized in California by constitutional amendment in 1910 and enforced by statutory enactment the following year and is said to have given entire satisfaction to the localities as well as to the state. In several states, including New York, Connecticut, Delaware, New Jersey, and Wisconsin, this principle is being applied gradually by providing part of the state revenue from special forms of taxation, while in Pennsylvania neither real estate nor personal property is taxed for the purpose of raising state revenue, which is obtained independently of the local revenue from corporate assessments. Thus we find several states seeking to avoid an unequal distribution of their tax burdens by limiting the general property tax to local purposes and by reserving for the use of the state excise fees, inheritance or income taxes and those of certain classes of corporations.

This plan for the separation of the sources of state and local revenue is entirely consistent with the policy of the centralization of administration which is one of the most characteristic and valuable features of the modern tax law, and it is in keeping with the general tendency in taxation. By virtue of this plan of separation the State is given full power to assess originally and to collect its own revenue directly.

It would also permit of any locality, desiring to do so, favoring new industrial or manufacturing concerns as is now done in New York, New Jersey and especially in Pennsylvania by temporarily reducing or waiving the taxes on this form of productive industry.

In the last edition of his most excellent *Essays in Taxation*, Dr. Seligman speaking of Corporations says: "Governments are everywhere confronted by the question, how to reach the taxable capacity of the holders of these (corporate) securities, or of the associations themselves. Whom shall we tax and how shall we tax them in order to obtain a substantial justice? Perhaps no question in the whole domain of financial science has been answered in a more unsatisfactory way. In the United States we have a chaos of practice—a complete absence of principle; in Europe, with the possible and partial exception of England, the

situation is scarcely, if at all better. Moreover, in spite of the generally recognized need of reform, there has thus far been no comprehensive attempt, from the standpoint of theory, to evolve order out of the chaos into which the whole subject is plunged."

While in primitive society property may be the best available test of ability in matters of taxation, the true test is always ability and not property, which is made use of only to measure taxpaying ability. The ability and the duty of the owner of property to support the government to the same extent and for the same reason that he supports himself and his family is measured most fairly and accurately by income or productive ability.

As society develops, economic and industrial conditions become more complex, property and industry assume more varied forms, and the capacity of the individual or corporation can no longer be fairly determined merely by property ownership. Whether a person is supporting his family on a salary income or from property investments he is equally able and responsible to assist in the support of the government. With the more complex industrial development of advanced civilization property becomes more varied in form and appearance as well as in its earning capacity, and it is submitted that the manner of its assessment should change with the form of the property being assessed in order that it may conform most completely to the particular class assessed, and be comprehensive of all classes and that the earning capacity of the investment or the income of the corporation should be the basis of the tax.

As civilization develops, the test or measure of ability to pay taxes must be shifted from property to product or income, and the inevitable failure of the property tax, which alone is a crude method of determining the ability and defining the duty to pay taxes, follows the failure to apply this test. Property, therefore, must be classified as to its form and productive capacity if we are to have a fair uniform and comprehensive system of taxation, based on ability to pay and universal in its application. Such a system would not only secure a fair division of the burdens of taxation but it should reduce the current tax rate one half, for probably less than half of the earning capacity of property and persons now pay all the taxes.

The bulk of our intangible property, which has generally escaped paying its fair share of taxes and which is rapidly increasing actually and relatively out of all proportion to other

property, especially as to its earning capacity, is invested or deposited with corporations. The general tendency and natural effect of corporate investment is to concentrate property for the purpose of increasing its earning capacity, thereby collecting into a relatively few business organizations or industrial systems practically all of the intangible, together with a large portion of the tangible property.

The small number of corporations as compared to the large number of owners of their securities affords a most compelling argument of convenience and economy for the taxation of the corporations rather than their securities in the hands of their numerous and widely scattered owners, many of whom are never found, so that the portion who are taxed are required to pay in addition to their own fair share of taxes an even greater amount which belongs to the owners of those securities which are not returned, with a resultant rate of taxation imposed on that portion actually paying, frequently approaching the earning capacity of the security itself. By taxing all such intangible property at its source or the place of its investment, the expense and difficulty of assessing and collecting the tax would be reduced to a minimum and the tax could be practically uniformly leveled and universally collected, with the result that the rate could be reduced one half. In other words, let us take the income or earning capacity of the corporation as the measure of its duty and ability to pay taxes and not attempt the impossible and inequitable assessment of its stock or property as such, especially when so much of the property is intangible in form and so incapable of assessment except on the basis of income or earning capacity.

The earning capacity of these corporate investments is determined by the integrity and efficiency of the organization issuing them, which depends upon its operating as a single entity or as an integral part of an industrial system, and only as such can they be fairly and completely reached for purposes of taxation. The earnings of such corporations assessed as received by them as single operating or going concerns rather than the valuation of their property as fixed by a number of local taxing officials often working independently of each other, determines, more conveniently and economically as well as far more accurately, the proper tax for each corporation. Earnings furnish a far more definite and convenient measure of tax paying ability than capital stock or property valuation where much of

the property is intangible, and so incapable of valuation except as it is measured and determined by the earning capacity or income derived from its use in the business of the corporation.

It is only by taking earnings or income for the measure of the value of the intangible property involved that the many forms of corporate excess or franchise assessments of corporations can be determined with any degree of accuracy or fairness. The franchise tax, as distinguished from the fees paid for the privileges of incorporation, is necessarily an arbitrary assessment unless it is fixed in proportion to the value or earning capacity of the intangible property in addition to the actual valuation of tangible property, and as the only practical measure of intangible value is its earning capacity the franchise tax unless arbitrarily assessed is in fact a tax based on or measured by earnings or income. There is economically no justification for a franchise tax that is not in effect a tax of the intangible property or its income, for the privilege of becoming a corporation and acting as such is logically paid for at the time of incorporation. A tax on corporations measured by corporate income should include every subject of taxation that is legitimately taxable from the economic point of view, for income covers all property and reflects all value necessarily and properly belonging to the corporation.

As income or earning capacity determines the value of the property belonging to corporations and furnishes the best measure of tax paying ability, why not tax it as such or use it directly as the measure of value in assessing such property? It is fixed and definite, not susceptible of evasion, easily and conveniently ascertained at slight expense to the State as well as to the corporation itself and furnishes a fair practical basis of assessment.

As Dr. Seligman in his *Essays in Taxation* observes: "The value of the franchise from the economic point of view consists in the earning capacity of the corporation. This is the real basis of all taxation and can best be gauged by the amount of business done. . . . In an economic sense the franchise tax means nothing at all. It is so utterly indefinite that it defies exact analysis. However valuable it may be to the lawyer in the effort to evade certain constitutional restrictions, to the student of the science of finance it is a useless conception."

Our present day system of corporate accounting and of state and federal regulation and control of corporations has greatly simplified and facilitated their taxation according to income or

earning capacity. Because of the nature of their investments and the variety of the forms of their property as well as the special privileges and obligations of public utilities, their taxation by the State according to their income, received within the State, affords the only adequate method, that is at once simple and comprehensive, of fairly and definitely assessing at least the intangible property and the productive ability of these public service corporations, which are seldom local and often interstate in their relations and operations.

Much of the property or capacity for earnings of public utilities is not represented by tangible property, and there seems to be a general tendency to abandon property in favor of gross earnings or receipts as the basis of their taxation because the necessary facts are readily available and the plan is simple and definite. This goes far to avoid the inaccurate and arbitrary features which at times characterize our present system or the lack of any fixed rules of assessment. In these cases publicity and a well defined system, easily administered and understood by all concerned, is the best precaution against inaccuracy, unfairness and suspicion.

As these corporations are subject to regulation by the State as to rates as well as service the facts as to their earnings are always available to the State, and, as under a system of taxation based on or measured by their income, the amount of their taxes would vary with their income as determined by the rate regulation of the State, so where only a fair return on the actual value of their property was received the tax would be fixed and limited according to their income, and should not include a franchise or excise tax in addition thereto.

While the net earnings tax may be the most logical form for the taxation of corporations, as theoretically it is perfectly proportional to productive capacity, the gross earnings tax was recommended by a special committee of state railroad commissioners, which as early as 1878 reported that: "The requisites of a correct system of railroad as of other taxation are that it should, so far as it is possible, be simple, fixed, proportionate, easily ascertainable and susceptible of ready levy. . . . The conclusion at which your committee arrived was that all the requisites of a sound system were found in taxes on real property and on gross receipts, and in no others."

An exhaustive report of a special commission for Connecticut on the taxation of corporations issued in 1913 declared in favor

of the gross earnings tax, saying: "The earnings of a corporation are the real basis of the value of its property, the value of its securities, and its tax paying ability. This statement will generally be admitted at once, and it is also demonstrated by the result of the experience of other methods of taxing corporations. As a matter of theory, the earnings of a corporation are the only true measure of its value and its tax paying ability. The basis of earnings is also the simplest in practice and the one that involves the least administrative difficulty. . . . The practical difficulties in the way of imposing a tax upon net earnings seems overwhelming. . . . The gross earnings tax, therefore, has the great advantage of simplicity, certainty, and ease of administration."

This is the position taken by the Ontario Commission of 1895, by the California Commission of 1906 and by those of Virginia and Rhode Island of 1911. Dr. Seligman, while ardently favoring the net earnings system as the ideal one which he hopes may be attained generally later under a better system of corporate accounting, says that: "As a matter of practical wisdom it may be conceded, however, that in not a few of the American States simplicity and convenience of administration are preferable to more ideal but more difficult methods."

The Rhode Island law of 1912 provides that intangible personality of public service corporations shall be reached through a tax based on gross earnings, and that of mercantile, manufacturing and miscellaneous companies through a tax based on corporate excess. These taxes are in lieu of all other taxes against intangible personality either to the corporation or to the holder of its securities. From the standpoint of ease of administration and the production of revenue, their board of tax commissioners has found that this tax on gross earnings for public utilities has met every expectation. This gross receipts method of taxation is employed exclusively or in part in nineteen states for the taxation of telegraph companies; in twenty states for telephone companies; in twenty-four states for express companies; in fifteen states for parlor and sleeping car companies; in ten states for street railways; in at least eight for railway companies; and in twelve for gas, electric light, heat or power companies.

Under this system of taxation, which continues to become more general, of course, it is necessary to classify corporations with respect to the prevailing ratio of their net to their gross earnings

and to impose different rates upon the gross earnings of corporations according to this classification. It is said that the ratio of net to gross earnings is fairly uniform for railroads, express, telegraph, telephone and most all public utilities, each of which are classified accordingly; and the prevailing ratio for each class having been determined, the rates are graduated according to the fixed ratio. This rate should be equivalent to that imposed on other forms of property or income in determining their tax paying ability and duty.

As such corporations often become interstate in the scope of their operation or distribution, uniformity of taxation among the states is essential to a fair and uniform distribution of the tax burden, and in view of the large number of states that have accepted or in which has been recommended the gross earnings system of taxation for these corporations it affords the most likely means, as it would seem to be the most practical method, for securing in interstate as well as in state and local fields uniformity in taxation. Every State should tax the income of all corporations actually earned within the State and only such earnings.

Upon the question of the State constitutional charges necessary to improve our systems of taxation, as herein suggested, it is pertinent in this connection to note that the United States Supreme Court some three years ago, in its decision of the case of *United States Express Co. v. Minnesota*, 223 U. S. 335, declared valid a tax of six per cent. imposed by the laws of Minnesota upon the gross receipts for business done in that State by the United States Express Company which was in lieu of all other taxes on the property of the company, because the court found this to be a fair means of assessment and an entirely proper method of taxing such company, although some of the receipts in question were the proceeds of interstate commerce. The constitutionality of an income or earnings tax in lieu of other property taxes as a federal question is therefore well established, so that such a tax is legally as well as economically sound.

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